THE PERFECT STOCK OPTION PLAN

PREPARED FOR THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

by

GRAEF CRYSTAL

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The purpose of this paper is to present the author's recommendations for "the perfect stock option plan", one that will eliminate totally, or at least substantially, the many abuses found in so many executive stock option plans in use today.

The paper is divided into two sections. In the first section, I discuss the many problems inherent in current option plans. In the second section, I present my recommendations for reform.

THE PROBLEMS WITH CURRENT STOCK OPTION PLANS

The Issue of Option Size

There is no question that the size of stock option grants has grown explosively over the years. From a minuscule part of CEO pay packages, they have now become the dominant part.

An illustration: In the 1960s, I was the compensation director of General Dynamics Corp., then the largest U.S. defense contractor, with over 100,000 employees. Each year, I surveyed the pay of other aerospace CEOs, as well as the pay of CEOs running non-aerospace companies of comparable size. The pay of Roger Lewis, then the CEO of General Dynamics, was positioned to keep him at the median of the comparator group market. Therefore, what he received is a good proxy for what other CEOs received during the mid-1960s.

For the five year period, 1963 through 1967, Lewis was awarded stock options covering a total of 15,000 shares. The options had a present value at grant of approximately $16,000 a year, according to calculations made using the Black-Scholes Option Pricing Model.

In November 2002, I performed a study covering CEOs running 180 companies, all with 2001 revenue of $8 billion or more. The average CEO in the study received options during the 1999 through 2001 period with a present value at grant that averaged $9 million a year. That's 562 times the present value of Lewis' grant during the mid-1960s.

The Emergence of the Option Mega-Grant

For many years, the most common practice was to give the CEO a regular annual option grant. But in the last 15 years or so, we have seen the rise of the option mega-grant, i.e., a huge grant of option shares, given not at annual intervals, but at periodic intervals.

An illustration here involves Michael Eisner, the CEO of The Walt Disney Co. Eisner received huge option grants in 1984, when he joined the company; in 1989 when he renewed his employment agreement for the first time; and in 1996 when he renewed his employment agreement for the second time. In his 1996 grant, he received, on a single day, options covering 24 million shares.

To understand the effect of the option mega-grant on CEO pay levels, one needs to understand how pay surveys are conducted.

In a so-called normal distribution, which on a graph produces a familiar bell-shaped curve, the average and the median are the same or very close to the same. But there are distributions that are not normal. Take stock returns, for example. If I buy a stock at $50, the most I can lose is $50. But my

potential gains are unlimited. In such a distribution, the average gain is always significantly higher than the median gain. The same is true of pay. After all, no one willingly works for less than zero, and everyone insists on at least a minimum pay level. But the upside is, as with stock returns, unlimited.

In working with asymmetric distributions such as executive pay, it makes a big difference whether the person conducting the survey uses the median or the average as the approximation of the "going rate".

Such surveys are traditionally performed by independent compensation consultants. Seeking to please their clients, almost all consultants use average figures and not median figures. That being the case, the inclusion of an option mega-grant in a data set can cause the resulting average to be wildly-higher than the median, with the result that the client who decides to pay the average ends up paying far more than the median. Then that company's action, which enters the consultant's database, gets passed on, in the manner of a virus, to the next client. And so forth.

The insidious effect of option mega-grants on the resulting survey averages can be seen in the case of Michael Eisner's grants. I estimate that the present value of his grants made in 1984, 1989 and 1996 were, respectively, $13.6 million, $50.2 million and $172.4 million. Thus, his 1989 grant was 3.7 times larger than his 1984 grant, and his 1996 grant was 12.7 times larger. Were the value of his grants to be included in consultants' databases, as I am sure they were, they would have the effect of significantly distorting the average grant size (as opposed to the median size). In turn, that distortion would then induce other companies to increase significantly the size of their grants, ad nauseam.

(In fairness to Eisner, a significant portion of his more recent option grants contained strike prices that were as high as 200 percent of the market price on the date of grant. Moreover, during the current slump in Disney's stock price, he has neither repriced his options nor received any new ones. His most recent option grants continue to be those given to him in 1996, almost seven years ago.)

The Timing of Option Grants

In earlier years, the common practice was not only to make option grants at annual intervals but at about the same time each year, e.g., at the January board meeting.

But with the rise of the option mega-grant came attempts to time the option grant so as to maximize the future gains of the CEO. Thus, the large option grant could be made just a few days before the company announced record quarterly earnings. Or it could be made just a few days after the company announced that its earnings were far below analysts' estimates. Either way, the CEO received a strike price (the price that must be paid to exercise the option) that, viewed in the context of recent prices either before or after the option grant, was ultra-low.

Option Repricings

The implicit compact between a CEO and his shareholders involving option grants was that the CEO would not make anything unless the company's stock price increased. But that is not what

happened in many companies, particularly in Silicon Valley. There, when the stock price decreased, the board invited the CEO to bring in his option certificate. Then on Page Three, where were to be found the words; “To exercise this option, you shall pay the company $50 a share”, the board erased the $50 figure and inserted the new lower figure of $25 a share. And if the stock dropped further, the board invited the CEO to bring in his option certificate again. And again. At Apple Computer Inc. there have been at least eight option repricings over the years. The comparable figures for Cypress Semiconductor Corp. and Advanced Micro Devices Inc. are, respectively, seven and six repricings.

The great bulk of option repricings were of the one-for-one variety. That is to say, you turned in one million shares carrying a strike price of $50 and received back another 1,000,000 shares, this time carrying a strike price of $25. Were the board of directors of a typical Silicon Valley company to be in the automobile business, they would gladly give you a 2003 Cadillac in return for trading in your 1971 model, with no extra cash required on your part to close the deal.

The Use of At-The-Market Options

The all but universal practice has been, and still is, to grant the executive an option the strike price of which equals the market price of the stock on the date of the option grant. In the days when options were the size of those received by General Dynamics’ Lewis, that presented no real problem.

But consider Steve Jobs, the CEO of Apple Computer. On January 12, 2000, he was handed an option covering 20 million shares and carrying a strike price of $43.59 a share and a term of 10 years. On the date the option was granted, an investor could have purchased a zero-coupon Treasury bond with a maturity of 10 years that would have guaranteed him, under any and all circumstances, save only the dissolution of the U.S. government, a compounded annual return of 6.99 percent a year. Yet if Apple’s stock grew at precisely 6.99 percent a year for the 10 years in Jobs’ option term, and if he then exercised his option on the very last day of that term, he would walk away with a pre-tax gain of $842 million. And for what? For giving the shareholders the very return they could have had with no risk and no nauseating ups and downs of Apple’s highly-volatile stock price.

Liberal Vesting Restrictions

Stock options are supposed to be so-called long-term incentives. Thus, they are designed to encourage the CEO to exhibit “Satan, get thee behind me” behavior and not, for example, to cut the R&D budget, or to cut product advertising or to cut product quality or to eliminate management development programs, all to maximize current earnings. To be sure, if the CEO spends what’s needed for R&D and for advertising and keeps product quality high and spends the funds necessary to develop new managers, current profits will arguably be lower. And the CEO may end up receiving a lower annual bonus as a result. But if his long-term actions bear fruit, he will more than make up for that bonus loss by receiving much greater option profits.

That's the theory. But if that theory were being followed, a CEO would not be able to exercise a single one of his option shares for, say, five years following their grant.

Such is not the case, however, in the vast majority of companies. Typically, 25 percent of the option shares in a grant may be exercised at the end of the first, second, third and fourth anniversaries following grant. Indeed, there are quite a few companies out there that make the entire option exerciseable within two years following grants. There are even companies that make the option exerciseable immediately.

By adopting such liberal exercise restrictions, the CEO is enabled to capitalize on short-term runups in his company's stock price, which is not what the option plan is supposed to permit.

Making Grants Right Up To Retirement

In the good old days, a company stopped making new option grants to a CEO when he was, say, within five years of his retirement date. But today, that practice has been abandoned. It is routine for a CEO to receive a last option grant during his last year before retirement – even, in some cases, within the last couple of months before his retirement.

Adopting Liberal Post-Retirement Option Terms

In more recent years, companies have allowed a retiring CEO to exercise his options at any time during their original terms, even if the original terms do not expire for close to 10 years after his retirement. The theory behind this practice is that the CEO needs to be "incented" to take actions that are in the long-term interest of the company and that therefore his full option terms should continue after his retirement.

It's funny when you think about it: The company making this statement about the need to "incent" long-term behavior is the very company that allows the CEO to exercise his options early in their terms, thereby vitiating the very concept of long-term behavior.

The Pernicious Effects of Stock Volatility

Consider here the case of Steve Jobs at Apple. As mentioned previously, he was granted the largest option in the history of mankind on Jan. 12, 2000 – an option covering 20 million shares and carrying a strike price of $43.59 a share.

Subsequent to the grant of that option, Apple' stock price plummeted. Between Jan. 12, 2000 and Oct. 19, 2001, Apple's total return was a negative 60.5 percent, which ranked it fourth worst among six major computer makers during that period.

Notwithstanding that poor performance, Jobs, on Oct. 19, 2001, was granted yet another stock option, this one covering 7.5 million shares and carrying a strike price of $18.30 a share.

Consider here a non-executive shareholder, who buys a share of stock at $50. If the stock rises to $75, then falls back to $50 and rises to $75 a second time, at which point the shareholder sells his

share of stock, he makes a profit of $25. But a CEO could make a profit of $50 by getting a first option a $50, exercising it at $75 and then, when the stock has fallen back to $50, getting a second option at $50 and going on to exercise it at $75. That, in short, is what could happen with Steve Jobs, although, to date, neither of his two option grants are above water.

To demonstrate how lucrative stock options can be in the face of stock price volatility, I constructed a mathematical model. I started by observing that, in a study involving option grants made in 2001 to 871 CEOs running companies with revenues of $1 billion or more, the median grant covered $6 million of stock. That is to say, the number of shares in the grant, when multiplied by the market price per share on the grant date, was $6 million. I therefore assumed that on Day One of a 20-year period, the CEO received a grant covering $6 million of shares. Then exactly one year later, I gave him a second grant covering shares worth, on the grant date, five percent more, or $6.3 million. I repeated this same progression nine more times, so that by the beginning of the 11th year, the CEO had received 11 annual grants, each covering shares worth five percent more than the year before.

I would note here that a five percent increase in stock option granting size per year is a highly-conservative assumption. To get from the $16,000 a year option present value of a Roger Lewis in 1965 to the $9 million a year present value of a typical major-company executive in 2001 requires a growth rate of 19.2 percent a year.

I then had the CEO exercise each grant on the last day of its ten-year term. Or, if the then market price was below the stock's strike price, the option was assumed to be canceled.

Assuming the market price on the date of the first grant was $50, the CEO would have received an option covering $6,000,000 / $50, or 120,000 shares. As for the second grant, if the stock price had by then increased to $60 a share, the grant would have covered $6,000,000 X 105 percent = $6,300,000 / $60, or 105,000 shares. On the other hand, if the stock had dropped to $40 a share, the second grant would cover $6,000,000 X 105 percent = $6,300,000 / $40, or 157,500 shares.

As can be seen, as the stock price increases, the number of shares in the subsequent grant decreases, while if the stock price decreases, the number of shares in the subsequent grant increases. This is the way most companies handle their option grants.

However, to make sure that an ultra-low stock price would not trigger an absurdly-high number of option shares in an ensuing grant, I put in a constraint to the effect that, no matter how low the future stock price dropped, the ensuing grant could not cover more than 600,000 shares.

The stock prices used for any run of my model were randomly distributed to produce a given average annual stock price growth rate and a given degree of stock price volatility. Each finding that shortly will be described is based on 1,000 runs of my model.

The first thing I noticed from all that computation was that there was no more than a two percent probability that a CEO would go away empty-handed from all 11 eleven of his option grants, no matter how bad the performance of his company was.

But what really astounded me was how much the CEO could earn from his combination of 11 different grants. Here, in summary form, is what I found:

- For a typical company with an 11.6 percent a year stock price growth rate and normal volatility of 40 percent, the CEO reaped gains of $240 million. Keep that growth the same but increase the volatility substantially to 63 percent, and the CEO gains $410 million.

- For a successful high-tech company with stock price growth of 19.4 percent a year and high volatility of 63 percent, the gains totaled $777 million. Increase the volatility a bit to 71 percent and decrease the growth rate to a meager 5.3 percent a year, and the gains still are $183 million. An investor, in most periods, could receive a return of 5.3 percent a year from utterly risk-free Treasury bonds, suggesting that a CEO running such a company should receive nothing.

- For an unsuccessful high-tech company, where the stock price growth was a negative 0.4 percent a year but where volatility was a very high 71 percent, the CEO nonetheless managed to haul away $83 million.

It is important to note that these huge gains did not take account of: 1)The use of mega-grants when the stock price had dropped in the recent past; 2)The use of option repricings for the same reason: or 3)The timing of option exercise to coincide with a sharp spike in the stock price. Therefore, when these factors are coupled with a mere five percent a year growth in option size, the staggering numbers just disclosed, far from being the norm, are actually quite conservative.

The Dividend Distortion

Almost all stock options entitle the holder to stock price appreciation. But they do not entitle the holder to receive dividends. Therein lies a conflict of interest.

Other things being equal, dividend-paying stocks offer less stock price appreciation than stocks which do not pay dividends. If this were not so, we would all flock to dividend-paying stocks.

Many commentators have noted that companies are no longer as fond of paying dividends to their shareholders as they used to be. A prime factor that contributes to this behavior is that stock options tilt the executive to retain earnings in the business for future investment. Thus, while the CEO is optimizing stock price appreciation, he may be sub-optimizing total shareholder return, the latter of which includes dividends and is of fundamental interest to investors.

Relaxation of SEC Rules

When I started working as a consultant, back in the 1960s, the U.S. Securities and Exchange Commission had very different insider trading rules than those prevailing today. Back then, if an executive exercised a stock option, he had to hold the shares for a minimum of six months before he could sell them. If the stock price fell after his exercise, the CEO’s gains could be totally wiped out. Indeed, not only could they be totally wiped out, but the CEO could also be exposed to an onerous tax liability.

After being worked over by lobbyists for companies, the SEC, in more recent years, has substantially relaxed the insider trading regulations, as they pertain to stock options. Now the option cannot be exercised for six months after its grant, but the shares can be sold the instant they are exercised.

The Use of Non-Independent Compensation Consultants

It is by far the most common practice for a compensation consultant to be selected by the CEO and to report to him. If he produces recommendations that the CEO finds satisfying, he is trotted out in front of the company's board compensation committee to present his thinking. On the other hand, if he produces recommendations that the CEO does not find satisfying, he is out on the street, and another, more compliant, consultant is retained.

In the meantime, the board compensation committee is left to its own devices. It is not invited to master the arcana of stock options. And given that it meets only a few times a year and then only for a short interval, the compensation committee, obligingly, does not master that arcana. The committee is almost never furnished a seeing-eye dog in the form of an independent consultant who is hired by the committee and reports solely to the committee.

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Having set forth the problems associated with stock options, permit me now to develop recommendations to eliminate, or at least substantially mitigate, those problems.

RECOMMENDATIONS FOR REFORM

Charging Earnings for the Cost of Stock Option Grants

The fact that liberal accounting rules have allowed companies to avoid charging their earnings for the cost of stock options has been the principal contributing factor behind the explosive size of stock option grants. Consider the case of Steve Jobs' 20-million share option grant in 2000. I estimated that the present value of that grant was $471 million. Would Apple's board have made that grant had it been required to charge Apple's pre-tax earnings by $471 million? I strongly doubt it.

Ray Lauver, a former board member of the Financial Accounting Standards Board (FASB), the rulemaking body for American accounting, once told me there was an ancient maxim in the world of accounting: "Never measured, never managed". He used that maxim to explain why stock options had gone out of control.

The reverse of that maxim is; "Measured, managed". Consider here what happened to post-retirement medical costs. In the old days, companies were allowed not to charge their earnings for the cost of post-retirement medical expense until that expense was actually incurred, often some 15-20 years after the employee's retirement. Pretty soon, people began to see this deferral of costs as something that

might one day bankrupt the company, especially as retirees were living longer and also especially as newer and more expensive medical procedures were being introduced seemingly daily.

A few years back, FASB changed its stance. It now requires companies to estimate the present value of future retiree medical expense and to begin charging it to earnings during the period when the retiree is employed.

That change brought about a revolution in company behavior. All of a sudden, former employees who had been retired for 15 years and who had been promised free medical insurance for the remainder of their lives were told their insurance was being canceled. Or if it wasn't being canceled, a stiff premium was being demanded for continuation of coverage.

"Measured, managed". That's what happens when companies are required to charge earnings for the true costs of doing business.

Parenthetically, and laughingly, many companies, especially those in Silicon Valley, have protested charges to earnings for stock options, because, in their view, those charges cannot be determined with exactitude. Yet those same companies don't object to charging their earnings for the estimated present value of medical procedures which have not yet been invented.

Warren Buffett once observed that he felt it to be harder to determine the exact period over which to depreciate his company's jet than to determine the value of a stock option.

By requiring charges to earnings for stock options, companies will likely stop making option mega-grants. In turn, average stock option size, as opposed to median size, will start to decline sharply. And with it will come a needed decrease in top executive pay.

Timing of Grants

Investors should demand that boards stop playing around with option grant timing. Indeed, they should demand that a company make an annual option grant to its top executives and at the very same time each year. Indeed, there would be nothing wrong with grants made each quarter. Such an approach would help to dollar average strike prices and thereby would provide a more stable platform from which to measure true performance over the long-term.

Option Repricings

In an ideal world, options should never be permitted to be repriced. However, in a more practical world, repricings are sometimes needed to keep executives from crossing the street and getting an at-the-market option from a competitor whose stock price has also dropped.

At the least, however, option repricings should be economically-equivalent. No more of that trading in your 1971 Cadillac for a 2003 model in an even exchange.

To achieve this economic equivalence, the company would use the Black-Scholes model to determine the estimated present value of the under water options being turned in. Then it would divide that value by the present value of a new option share carrying a strike price equal to the current market

price. The result will be that, if the CEO turns in, say, one million shares carrying a strike price of $50 a share when the market price is $25 a share, he will find that he does not receive back one million shares carrying a strike price of $25 a share. Rather, he will receive back a much smaller option, say, an option covering only 350,000 shares.

All publicly-traded companies utilize the Black-Scholes model in one way or another, even though many of them do not think the model provides a truly accurate estimate of an option's value. A small, but growing, number of companies have decided to begin charging the cost of stock options to their earnings, and to do this they must use the Black-Scholes model (or one of its offspring, such as the Binomial model). The vast majority of companies, however, do not believe that charging earnings for the cost of stock options is a good idea, and they continue to follow Accounting Principles Board Opinion Number 25, which allows them to avoid charges to earnings for stock option grants, provided that the strike price of the grant (i.e., the price that must be paid to exercise the option) is at least as high as the market price on the grant date. Nonetheless, companies in this latter camp are required to include in the footnotes to their income statement a presentation showing what the company's earnings per share would have been had the company charged its earnings for the cost of stock options in accordance with Financial Accounting Standard 123. To make this calculation, the company, once again, must employ the Black-Scholes option model (or one if its equivalents). Then, too, virtually every company participates in compensation surveys conducted by consulting firms, and the great majority of these surveys use the Black-Scholes model to produce figures that can be compared from one company to another.

Vesting Restrictions

To ensure that a stock option really does its job as a long-term incentive, no option should be permitted to be exercised in fewer than five years following its grant.

Grants Near Retirement

Option grants for top executives should cease being made when the executive is within three years of his normal retirement date.

Post-Retirement Exercise Terms

Stock options should carry a term that does not extend beyond three years past the executive’s retirement.

Indexed Options

To insure that executives do not receive substantial sums of money for performance that is no performance at all, the strike price of stock options should be indexed.

Two choices are available here: 1)The use of a broad market basket of companies, such as those comprising the Standard & Poor's 500 Index: or 2)A market basket of companies in the same industry.

Whatever market basket is chosen, it should contain a sufficient number of companies so as to provide a stable basis of comparison.

Comparisons should be made on a total return basis, that is, including dividends, and not on price appreciation alone.

In addition, I would recommend that comparisons be made on an unweighted basis, i.e., without giving effect to the various market capitalizations of the companies comprising the index.

Moreover, I would recommend that the option's strike price be indexed, not to the median or average growth in the returns of the companies comprising the index, but to the 25th percentile of the distribution, i.e., the bottom quarter. The purpose here is not to penalize a CEO for slightly-below average or below-median performance but only for performance that is truly poor.

At the same time, I would require that the movement in the option's strike price be, in no event, less than the return rate on a 10-year, zero-coupon Treasury bond.

For an illustration here, assume a CEO receives an option covering one million shares and carrying an initial strike price of $50 a share. At the time of the option's grant, an investor could receive a compounded annual return of 5.00 percent from a zero-coupon Treasury bond carrying a maturity of 10 years.

Using the Treasury bond test, the strike price of the option would be increased by five percent a year. Thus, the strike price at the end of Year One following the grant would be increased to $50 X 105 percent, or $52.50. And at the end of Year Two following the grant, the strike price would be increased to $50 X 105 percent X 105 percent, or $55.13. Thus, at the time the grant was made, the strike prices for all future years for the grant's life would be established under the Treasury bond test.

However, in any year when the 25th percentile return for the cumulative time period was higher than the cumulative return for a Treasury bond, then that higher return would be applied to the option's strike price for that year.

Consider here the end of Year Two following the grant. At that point, the strike price would be slated to rise to $55.13 under the Treasury Bond method of computation.

However, let's assume here that the 25th percentile return of the market basket of stocks for the two-years the option has been in existence is 15 percent. On that basis, the strike price at the end of Year Two would be adjusted, not to $55.13, but rather to $50 X 115 percent, or $57.50.

On the other hand, if the 25th percentile return of the market basket of stock was a negative 10 percent, the strike price would nonetheless rise to $55.13, the level dictated by the Treasury share method.

Some economists would be satisfied only to use a market index to adjust strike prices. But under that approach, a CEO running a company that generated a negative return, but a negative return that was

less negative than the return of the underlying index, would receive an economic benefit. The concept of rewarding a CEO for negative performance may seem quite comfortable to economists, but I doubt that it would seem comfortable to your average shareholder. To me, using a lesser index hurdle, i.e., the 25th percentile, instead of the market-cap weighted average, and then imposing an absolute minimum increase in the strike price each year using the Treasury share method, is the better approach. Among other things, it would never result in the CEO being rewarded for negative stock price performance.

The Use of Dividend Equivalents

To create a level playing field as between stock price appreciation and dividends, executive stock options should carry dividend equivalents. Consider here a one-million share option carrying a strike price of $50 a share and a dividend of $1 a year, paid annually.

At the end of Year One, the dividend on one million shares would be $1 million. If by then the stock price had risen to $60 a share, the executive would be credited with $1,000,000 / $60, or 16,667 free shares. One year later, let's assume the stock price has risen to $70 a share and the dividend to $1.10 a share. In that case, the executive would receive dividend equivalents on his original 1,000,000 shares, as well as the 16,667 shares credited from Year One. He would therefore receive an additional (1,000,000 +16,667 = 1,016,667) X $1.10 / $70, or 15,976 shares.

The free shares relating to any given option grant would not be available to the executive unless he exercised the option. If, for example, the option expired without exercise, the executive would forfeit the shares. He could, if he wished, exercise the option at the end of its term, even though it was under water, assuming the value of the dividend shares he would subsequently receive exceeded the penalty imposed by exercising an under water option.

At first glance, the recommendation to offer dividend equivalents on stock options looks to be a giveaway. But the present value of an option carrying dividend equivalents would be comparably greater than the present value of one without dividend equivalents. Therefore, a company that was charging its earnings for stock option grants would find that it could not give as many dividend-carrying options as traditional options, i.e., options not carrying dividends.

By using dividend equivalents, CEOs would no longer be "incented" not to pay dividends and instead to retain earnings in the business. Rather, he would be in a neutral position and therefore might be expected to do what is right for shareholders.

Adding Further Restrictions

Indexing a stock option, as recommended above, will help to cut down on gains for what turns out not to be stellar performance. But indexing won't solve the problem entirely. That is because, if the stock price drops, the CEO can receive a new annual grant at the lower stock price, and then the indexing starts over again.

There are various ways to dampen this problem. But a simple way that I find attractive is to hearken back to the way the Federal government handled so-called Qualified Stock Options (QSOs) in the 1960s and 1970s.

One of the requirements of a QSO was that an option could not be exercised so long as there was outstanding an earlier-granted option carrying a higher strike price. In other words, if you had a luscious option with a low strike price, because your company's market price had declined substantially, you could exercise that option but only if you first exercised earlier options carrying a higher strike price.

The re-imposition of that requirement would go a long way to taking away the punchbowl of option profits deriving from high stock price volatility.

Re-imposing Holding Requirements

Although current SEC rules are lax, boards could impose their own rules. In effect, a CEO who exercised a stock option would either be required to take his gain in free shares of stock, which would then be restricted from resale for, say, one year. Alternatively, if the CEO purchased the option for cash, he would be required to hold the resulting shares for the same period of time.

The reimposition of holding periods will help to ensure that what a CEO earns from a stock option is the result of true long-term success and not spurious blips in stock prices.

Hiring Consultants for the Board

Board compensation committees should have their own compensation consultants. The consultant should not report to the management of the company in any way. Moreover, none of the consultant's partners or other colleagues would be permitted to do business of any sort with the company. For example, the consultant's partner would not be permitted to do actuarial pension valuation work.

I would go further here. The consultant would be required to be present at each meeting of the compensation committee. Moreover, his recommendations would be required to be given in writing so that they would be part of the corporate record in the event of a subsequent lawsuit.

In addition, the name of the consultant's firm would be required to be divulged to shareholders annually, so that the cumulative record of consulting recommendations by a particular firm for its many clients could be compiled and evaluated.

Finally, if the consultant were changed, the board compensation committee would be required to cite its reasons for the change. And the consulting firm being terminated, if desired, would be permitted to offer its own explanation as to why it had been removed

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I believe that if the aforementioned recommendations are implemented, the abuses presently found with stock options will be eliminated or at least substantially mitigated. In turn, options will be permitted to continue their job of rewarding true long-term performance.